

July 16, 2004

Senate Committee on Finance  
Attn: Editorial and Document Section  
Rm. SD-203  
Dirksen Senate Office Bldg.  
Washington, DC 20510-6200

Re: comments in response to discussion draft released by Finance Committee staff on reforms and best practices in tax-exempt organizations. Submitted by John H. Graham IV, CAE, President and CEO, American Society of Association Executives, 1575 I Street NW, Washington, DC 20005.

**American Society of Association Executives.** The core purpose of the American Society of Association Executives (“ASAE”) is to advance the value of voluntary associations to society and to support the professionalism of the individuals who lead them. ASAE membership consists of professionals who manage or work for virtually every kind of tax-exempt organization, including trade associations, individual membership organizations, and charities. Nonprofit organizations can be broken down into a variety of subsections, including religious, social welfare, fraternal, business leagues, and philanthropic, but all exist to serve and provide value to their members or other constituencies, including the public. The nonprofit community acknowledges the increasing attention paid to the issues of governance and “best practices” and is committed to assuring strong fiduciary controls and accountability to members, donors, grantors and other stakeholders.

**Introduction.** As ASAE has previously testified before the Committee, tax-exempt nonprofit organizations are organized for a “higher purpose,” often to provide a valuable role or function that might otherwise fall to the government. ASAE believes that sound governance and transparency benefit both nonprofit organizations and the communities they serve. While not untouched by isolated instances of fiscal mismanagement or ethical abuse, the vast majority of nonprofit organizations have embraced their responsibility to institute governing practices that ensure public trust. That said, ASAE is aware of the Committee’s ongoing investigation of the nonprofit sector, and is appreciative of the opportunity to comment on the “work-in-progress” discussion draft prepared by Senate Finance Committee staff following the recent June 22 Finance Committee hearing on charity oversight and reform. The following are comments on proposals of particular relevance or concern to ASAE and its members:

**Five-year review of tax-exempt status by the IRS.** ASAE believes this proposal could prove onerous for many tax-exempt organizations, as well as for the IRS, which has already made known the challenges its Exempt Organizations (EO) Division faces in its oversight of more than 1.6 million tax-exempt nonprofit organizations.

Requiring organizations to re-apply for exempt status every five years, by re-submitting bylaws, articles of incorporation, management policies and financial statements, would

be duplicative, and an unnecessary allocation of staff time and other resources. Many, if not most, nonprofits are already labor- and resource-challenged, and some have no paid staff at all. The discussion draft makes no mention of whether this proposal would apply only to tax-exempt organizations of a certain budget size or type, so ASAE can only assume it is intended for all tax-exempt nonprofit organizations.

The IRS would also need to commit huge amounts of resources to this review process on an ongoing basis, increasing its attention on basic qualifications for exempt status and weakening its ability to focus on clear instances of abuse and increasing its field presence. The IRS is already examining the Form 990 as part of an ongoing effort to reduce paperwork burden.

ASAE supports many of the recommendations made by the IRS's Advisory Committee on Tax Exempt and Government Entities at a public meeting June 9, 2004, which focused on enhancing EO enforcement and compliance by hiring additional examination agents and improving training; establishing a standing Form 990 review committee to continuously evaluate the quality and utility of the information submitted on Form 990; and increasing the number of "limited scope" audits IRS performs as well as the number of "soft" contacts it makes each year, to increase the number of organizations examined.

ASAE is also in favor of a recommendation from the ACT report that the EO Division more regularly issue technical and precedential guidance for the exempt community so that these organizations can more easily comply with the law. In particular, ASAE is eagerly anticipating the release of the IRS's market segment studies of the exempt sector, first initiated in 2002. Between 100-150 501(c)(6) trade associations, 501(c)(5) labor unions, and 501(c)(7) social clubs were randomly selected by the IRS in 2002 to provide detailed information about their compliance and their use of IRS resources. Other categories of exempt organizations have since been surveyed as well. The IRS has stated that the shortage of trained staff and resources has prevented the EO Division from completing any of these studies to date, but ASAE believes this type of guidance, when published, will enhance voluntary compliance within the exempt sector.

Nowhere in the ACT report is the suggestion that the EO Division could efficiently administer an ongoing review of every nonprofit's tax-exempt status, and still achieve its other enforcement and compliance objectives.

### **Improving the quality and scope of Form 990 and financial statements.**

Organizations with tax-exempt status and \$25,000 or more in gross receipts file an annual Form 990 exempt organization information return with the IRS. The Form 990 (and related Forms 990-PF and 990-EZ) is the primary document used by both state and federal regulators to obtain financial and programmatic information about an exempt organization. All nonprofit organizations must make their last three Form 990s widely available for public inspection, either in person or through posting on a Web site.

Although a useful reporting tool, caution is warranted in relying on the Form 990 to make definitive conclusions about an exempt organization's expenses and operations. As noted

in the discussion draft, the Government Accountability Office (GAO) has issued similar concern in a 2002 report to this Committee entitled “Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities,” which calls into question the lack of common standards for filing Form 990. “Charities have considerable discretion in recording their expenses in the program services, general management, and fundraising categories,” states the GAO report. “Different approaches for charging expenses as well as different allocation methods can result in charities with similar types of expenses allocating them differently among the three categories.”

ASAE is not fundamentally opposed to the promulgation of standards for filing Form 990, so long as consideration is given to the administrative burden of compliance with any enhanced set of standards. The IRS earlier this year estimated that 287,769 organizations file the Form 990, and further estimated that the time required to file is 167 hours, 23 minutes per respondent. The estimated total annual burden for all 287,000+ exempt organizations is 48,166,918 hours. ASAE asks that the ability of these exempt organizations to carry out their vital missions not be impeded by the creation of more rigid reporting requirements than are necessary for proper disclosure. A balance must be struck between the need for additional information and the potentially unnecessary hardships an expanded set of requests may impose on the filing organizations.

The IRS has reportedly compiled extensive written comments and suggestions aimed at improving the Form 990 as a compliance tool, and it may be worthwhile to wait for the agency to release its proposed modifications for Form 990 before taking further action. Additionally, the recent ACT recommendation to establish a standing Form 990 review committee within the EO Division could ensure that the quality and utility of the information submitted on Form 990 is evaluated on a continuous basis. ASAE would pose to the IRS and other oversight agencies that the views and expertise of nonprofit leaders be represented should any such review committee be formed.

**Encouraging strong governance and best practices for exempt organizations .**

Certainly, it is the consensus of the nonprofit community that transparent decision-making, accurate financial reporting, and use of accepted auditing procedures will reduce the likelihood of abuse within the nonprofit community and protect the public trust essential to member- or donor-based organizations.

The discussion draft prepared by Committee staff focuses on the role of boards of directors or trustees; board composition; board/officer removal; the encouragement of “best practices”; and funding to support accreditation of charities nationwide.

Nonprofit organizations have overwhelmingly considered the governing board – whether it’s a “board of directors” or “board of trustees” – as a policy-setting body that defines itself apart from employed executive management. Nonprofit boards are increasingly accountable to members, donors, or other constituents of an organization. Every state’s nonprofit corporation statute already grants the authority and imposes the responsibility on boards to actively govern. On infrequent occasions, courts have held nonprofit board

members – even those who serve voluntarily and without compensation – personally and individually responsible in serious cases of failure to govern conscientiously.

ASAE would point out that it is unclear in this portion of the discussion draft whether the proposals addressing governance and best practices are meant to apply to charities only, or all exempt organizations, but regardless, most of the discussion points outline functions already undertaken by nonprofit boards.

The recommendation in the discussion draft that boards must review and approve the auditing and accounting principles and practices used in preparing an exempt organization's financial statements and retain the organization's independent auditor, is a perfectly acceptable alternative to requiring the establishment of an independent audit committee -- a standing committee of the board -- as is currently required of publicly-traded companies. While advisable for exempt organizations of a certain size, e.g. budget size of \$1,000,000 or above, the audit committee approach may be unworkable or just unnecessary for smaller nonprofits, requiring additional staff and volunteer time and likely increasing audit expenses. Even without the audit committee requirement, however, governing boards of exempt organizations must attend to their financial responsibilities. Additionally, governing boards are partners along with outside auditors in assuring that financial reporting is timely and accurate.

Most tax-exempt organizations also have in place a clear set of standards, guidelines, rules, or other directives that address the roles and conduct of volunteer leadership. Special consideration is usually given to conflicts of interest. Typically, a nonprofit organization's governing board will define in policy what it regards as "other interests" requiring disclosure by officers and directors. Simple disclosure of "other interests" may be sufficient in certain situations, and in other instances, boards may decide that the "other interests" warrant recusal or other correctives.

On the issue of board composition, the discussion draft clearly recommends that boards be "comprised of no less than three members and no greater than fifteen." It fails, however, to go into any detailed reasoning for this size restriction. According to a BoardSource survey, "A Snapshot of America's Nonprofit Boards," the average size of a nonprofit board is 19, the median being 17. Organizations with larger budgets also tend to have larger boards. In most states, the laws dictate the minimum size for nonprofit boards. Usually, it is three but in some states only one or two board members are required. It is difficult to put a definitive cap on optimal board size, as it may vary according to the moment in the board's life cycle, its mission, its fund-raising necessities, and whether it is a national or a local board.

**Funding of exempt organizations and for state enforcement and education.** ASAE is deeply concerned about any proposal to tax the net investment income of private foundations, or to institute a filing fee for all organizations that file the Form 990 (or 990-EZ, or 990-PF) based on the organization's gross receipts or assets.

Proposals to tax the investment income of trade and professional associations in Fiscal Years 2000 and 2001 were met with vigorous opposition from the nonprofit community, as well as a bipartisan majority of Congress. ASAE submits that exempt organizations rely on investment income to carry out a host of activities in connection with their exempt missions – activities that ultimately benefit American society. Further, nonprofits use this income to create small reserve funds to guard against future economic difficulties.

Similarly, imposing a filing fee on organizations that file Form 990 with the goal of raising up to \$200 million in revenue to pay for the proposed five-year review of exempt groups and other purposes is potentially crippling to many nonprofit organizations. ASAE would argue that it is fundamentally wrong to require the tax-exempt community to finance a costly, unnecessary and endless review of every entity carrying exempt status. These organizations undergo a careful and thorough review of their bylaws, articles of incorporation and management policies at the time they apply for exempt status. They also disclose financial statements on an annual basis. Requiring nonprofit organizations to pay a filing fee for their required returns to the IRS only takes resources away from these organizations' vital programs and services. It is sometimes necessary to remind outside audiences why these organizations exist in the first place. ASAE again urges the Committee, the IRS, state agencies and other oversight entities to bear in mind the differences between corporations and the nonprofit sector, understand that exempt organizations are often resource-challenged, and protect the ability of these organizations to carry out their essential missions. ASAE respectfully offers its assistance, expertise and knowledge as the Committee continues its examination of possible reforms and best practices in the tax-exempt sector.

Sincerely,

A handwritten signature in black ink, reading "John H. Graham IV". The signature is written in a cursive, flowing style with a prominent "J" and "G".

John H. Graham IV, CAE  
President and CEO